FEDERAL OPEN MARKET COMMITTEE MEETING TRANSCRIPTS

Prefatorv Note

The 1995 transcripts, prepared shortly after each meeting or conference call, were produced by the FOMC Secretariat from recorded proceedings of the meetings. The Secretariat lightly edited the speakers' original words to facilitate the reader's understanding. This editing involved some rewording, primarily for syntax purposes, or in some instances to complete or clarify a speaker's thought or to correct an obvious misstatement. But in no case did the editing alter the substance of the comments made. Meeting participants were then given an opportunity to review the transcripts for accuracy.

In a very small number of instances, passages have been deleted to protect confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

May 23, 1995

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 23, 1995, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Blinder
Mr. Hoenig
Mr. Kelley
Mr. Lindsey
Mr. Melzer
Ms. Minehan
Mr. Moskow
Ms. Phillips
Ms. Yellen

Messrs. Boehne, Jordan, McTeer, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Forrestal, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Davis, Dewald, Hunter, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors
Mr. Simpson, Associate Director, Division of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Beebe, Goodfriend, Lang, Rosenblum, and Mses. Tschinkel and White, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, Philadelphia, Dallas, Atlanta, and New York, respectively
Mr. McNees, Vice President, Federal Reserve Bank of Boston
Mr. Altig, Assistant Vice President, Federal Reserve Bank of Cleveland
Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

Transcript of Federal Open Market Committee Meeting
May 23, 1995

Secretary's note: In keeping with the Committee's decision at its meeting on January 31-February 1, 1995 that discussions not related to monetary policy need not be recorded, no recording was made of the first item discussed by the Committee at this meeting. The topic related to organizational matters that included rules on attendance at FOMC meetings and access to confidential FOMC materials at Federal Reserve Banks. A summary of the discussion is contained in the minutes published for this meeting.

CHAIRMAN GREENSPAN. Would somebody like to move the approval of the minutes for the March 28 meeting?

MS. MINEHAN. So move.

CHAIRMAN GREENSPAN. Without objection. We now turn to Peter Fisher who will report on the operations of both the foreign Desk and the domestic Desk.

MR. FISHER. Thank you, Mr. Chairman. I will first discuss current conditions in interest rate markets and then some of the factors contributing to recent exchange rate movements before reviewing foreign and then domestic operations. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Peter?

MS. PHILLIPS. In the domestic report, you indicated that a group of traders was "priced out of the market." What does "priced out of the market" mean, and how do you know they were priced out?

MR. FISHER. If you are taking a short position on the expectation that the data will lean the other way or the market will not continue to rally, you begin to lose a lot of money and you have to cover your shorts. There are people who believe that there will be a rebound in activity by the end of the year, but it is too expensive for them to try to express that position in the market.

MS. PHILLIPS. Do you take a survey or--

MR. FISHER. We talk to people, and there are some well known losses that are now reported. We certainly talk to the dealers about major positions that go against them. So, yes, there are informal surveys and some more formal surveys.

CHAIRMAN GREENSPAN. I think the Governor is asking the question, "What in the world does it mean to say you are priced out of the market?"

MS. PHILLIPS. That's right. [Laughter]

MR. KOHN. You lose a lot of money! [Laughter]

MR. FISHER. I think, as Don said, you lose a lot of money. There were people who were priced out of the market in December. They thought that the fed funds rate might not be raised 200 basis points in 1995 and that the yield curve had moved well beyond where it would go. But they chose not to express that view in the market in December.

CHAIRMAN GREENSPAN. Governor, what he is saying is a euphemism for indicating that they were wrong and that the price they are looking at now is too high to buy.

MS. PHILLIPS. Thank you.

CHAIRMAN GREENSPAN. Did I get it right, Peter?

MR. FISHER. Sure. [Laughter]

CHAIRMAN GREENSPAN. Any other questions? President Forrestal.

MR. FORRESTAL. Peter, what effect, if any, would you expect the threatened trade sanctions with Japan to have on the foreign exchange markets?

MR. FISHER. There were various stages in their announcement process. One of the earlier, more definitive, announcements actually had a positive effect on dollar/yen--modestly positive. I think I have described my views to the Committee before on this. When the markets perceive trade policy statements to be just saber rattling and no action is anticipated--just a lot of angry words--that tends to be negative for the exchange markets because they don't perceive that anything concrete will be done. But on the few occasions when our trade representative has announced concrete trade policy steps, whether sanctions or invocations of statutory authority, the exchange market for dollar/yen generally has responded positively on the theory that at least the sign is right for the impact on our short-run trade position.

CHAIRMAN GREENSPAN. Further questions for Peter?

MR. BLINDER. Peter, you talked about a coupon purchase operation in the last maintenance period and about the possibility of two such operations in the intermeeting period coming up. This raises a question I have wondered about for a long time, which is how you decide what to buy. There is a whole variety of securities out there. I was just looking at the table in your report which shows that about 50 percent of our portfolio is now invested in Treasury bills, with various percentages in other maturities. It is not obvious what the criteria are nor what the long-run goal is--if there is a goal for the maturity structure--nor how individual purchases and runoffs of securities contribute to or detract from that goal. What do you have to say about that? Do you feel that you know what the criteria are?

MR. FISHER. No, I don't, and I would like to look into and clarify some of the criteria that we use to approach this task. The presumption for several years has been that we are really replicating the portfolio as it exists. So, there is simply an effort to maintain roughly the current maturity mix. That is the policy that I inherited and it can be seen in effect in the new tables that we provide at the back of our report. It is a policy that I have been trying to understand better and to think through some of its implications. It is something that we have begun to work on. We contemplate having a few staff people devote a fair amount of time over coming months to thinking through the criteria that we use as we approach each auction. The tradition has been to assume that we wanted a relatively high component of bills to permit the portfolio to run off rather easily without the need to sell a lot of securities into the market and disturb the structure of the yield curve, if such an occasion were to arise. So, that is the nature of the received wisdom and how I intend to proceed.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. As a follow up, would that review also include the absolute size of passes and their impact on the composition of the permanent portfolio?

MR. FISHER. Yes. The presumption as to the size of each pass is sort of built into the assumptions about how we operate. We have to look at the two together.

MR. KELLEY. Right.

MR. FISHER. We will be looking at that. There are arguments for smaller passes with more frequent operations; there are arguments for larger ones. I have had some very interesting discussions with other central bankers in my position about the nature of a central bank portfolio and how to think about it. There is not much divergence in practices, but there is a wide range of views about how to think about this. One central banker feels very strongly that a central bank's portfolio should never contain on-the-run securities. A central bank, after all, makes its own liquidity. Why does the central bank need to hold on-the-run issues? The central bank should exclusively be buying everything that is off the run. But in practice, of course, that would involve the Herculean effort of being the vacuum cleaner of the securities market.

CHAIRMAN GREENSPAN. Especially if you have to sell.

MR. FISHER. Yes.

CHAIRMAN GREENSPAN. And to whom.

MR. FISHER. And to who.

CHAIRMAN GREENSPAN. And to <u>whom</u>. [Laughter]

MR. FISHER. Yes.

CHAIRMAN GREENSPAN. I'm sorry Peter, I just thought I would pick on you this morning. I took a pill that says, "Pick on Peter."

MR. FISHER. That's fine.

MS. MINEHAN. He can take it.

MR. FISHER. So, there is a wide range of views. A number of central banks that apply very sophisticated approaches to their foreign currency portfolios--really as profit centers--have been backfitting some of that financial technology into thinking about their domestic portfolios.

CHAIRMAN GREENSPAN. Can I suggest that we consider this issue periodically? The issue raised by Governor Blinder is something that is very important for us to look at. The way you phrased your answer, Peter, I think underscores that. To maintain the status quo really makes no sense whatever. The crucial question is: What liquidity needs do we have and what are the implications? I hope that you and Don can get together and come up with a report that gives the Committee some insight into what the principles should be.

Let me just state my own view of what I would like to see in that report: What would have been the consequences, for example, if a few of the major money center banks had gone belly-up in 1990, which was not an altogether bizarre possibility, and of the possible discount window lending that could have required huge liquidations from our portfolio? Secondly, there is the interesting question of whether in fact we could get both that scenario and the need for a major accumulation of foreign currencies. My suspicion is that the two contingencies probably would involve disparate economic events and it is very unlikely that they would come together. But we could face the need to acquire very large amounts of foreign currencies over a short period of time.

Finally, I think it would be useful to get a notion of the effect of changing the maturity composition of our portfolio on the portfolio held by the public. That ultimately affects the sensitivity of interest payments in the budget, taking into account Federal Reserve earnings, to changes in market interest rates. Clearly, we have been very much inclined over the years to try to stay away from a position where the short-term interest rate actions of the Federal Reserve could have pronounced federal budget effects. To the extent that we lengthen the average maturity of our portfolio and the Treasury does not offset what we are doing, that creates a portfolio with an increasingly shorter average maturity in the hands of the public. Therefore, the consolidated interest costs including Federal Reserve earnings tend to be more sensitive to changes in interest rates--obviously in the direction of higher rates being associated with higher federal outlays. I don't know how sensitive that relationship is, but I do think that the argument should be to get as much liquidity as we mught conceivably need in the context of whatever we view as a potential amount of resources that might be drained from our balance sheet and then multiply it by some number like they do at the BIS--I think it is three. [Laughter] I don't know whether three is the magic number, but there should be some criteria.

I think Governor Blinder raises an important issue. We have this huge portfolio, and we don't really have a set of principles that this Committee determines and I think we should. So, I would appreciate it if, sooner rather than later, you could come up with a set of principles that we can then debate at some meeting. Any further comments on this?

MR. MCTEER. I wonder if Peter would comment on whether he is holding the fed funds rate up to 6 percent or down to 6 percent.

MR. FISHER. By normally leaving the market a little short, we continue to push the rate in that direction. The rate expectations can be seen in the fed funds futures contracts. Both my report and Don's report indicate that the market is looking for the funds rate to be edging down, or skewed slightly in that direction, over coming months. We do not feel a great deal of pressure in the reserve market itself. I wouldn't relate this to the substance behind your question, but there have been some occasions where demand for excess reserves seemed a little on the soft side in the last few weeks. I think that is more of an anomaly, but it is something that I am intrigued with. There was one period in which the demand for excess reserves was really extraordinarily soft; we still have not gotten our hands on the reason for that excess level below $1/2 billion. I don't see that as a profound change but more as a fluctuation in the reserve market itself. But the market's forecast certainly is leaning in that easing direction. I don't think we have quite felt that in our reserve management yet.

CHAIRMAN GREENSPAN. Further questions? If not, we need to take three votes. The first is to ratify the foreign currency transactions since the last meeting.

VICE CHAIRMAN MCDONOUGH. Move approval.

CHAIRMAN GREENSPAN. Is there a second?

MS. MINEHAN. Second.

CHAIRMAN GREENSPAN. Without objection. Second, we will need to ratify the domestic operations during the intermeeting period.

VICE CHAIRMAN MCDONOUGH. Move approval.

CHAIRMAN GREENSPAN. Without objection. Finally, Peter has requested an increase in the intermeeting leeway from $8 to $10 billion. May I have a motion on that?

VICE CHAIRMAN MCDONOUGH. Move approval of the $10 billion limit.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Now let's go on to Mike Prell.

MR. PRELL. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mike? Mike, I meant to look up something before we came in. I don't know if you have the data with you, but what is the gap between new orders of durable goods and shipments in the last report?

MR. PRELL. It will take me a minute or so to find that. I think we are still seeing rising backlogs.

CHAIRMAN GREENSPAN. My recollection is that we have a spread of several percentage points. The reason I raise the question is to gauge how much of a drop in new orders can occur in the near term without unfilled orders also turning down.

MR. PRELL. I can't give you that answer immediately. I'm sorry.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mike, the forecast that you gave has the core CPI running at roughly 3 percent throughout the last half of 1995 and all of 1996, and you have built in, of course, the assumption of a flat fed funds rate at 6 percent. Just looking at those two numbers would mean that the real fed funds rate would be roughly 3 percent during this period. We have often talked about the concept of a neutral monetary policy. I am wondering how you would relate that real fed funds rate to the idea of a neutral monetary policy--whether you see this as a neutral monetary policy.

MR. PRELL. I don't have in mind a particular number that goes with neutrality in the sense that over time one would expect the economy to grow at potential--or to sit at potential output. We have interpreted monetary policy per se as probably modestly restrictive at this point. That is, the real rate of interest is perhaps somewhat above the natural rate. But, in the total financial picture, we also recognize that credit availability if anything has been improving; the terms and standards of bank loans have been moving in an easing direction; and we also have had an impulse through the exchange market, which you might take as part of the broader financial context, that is tending to be stimulative over this period. So, on balance, we don't have a picture of very marked financial impetus or restraint.

MR. MOSKOW. But is there a zone or number that you think of as a neutral monetary policy?

MR. PRELL. We would anticipate, particularly in an environment of ongoing fiscal restraint, that the equilibrium as we look ahead to 1996, 1997, 1998 would be one in which the real short-term interest rate would move closer to its historical average; that rate would be on the order of 2 percent or maybe a bit less. This would suggest that the rate probably is higher now than would be expected over the longer term. So, we have some restraint there. Don points out to me that we have had a very big run-up in the stock market that is providing another financial impulse.

Mr. Chairman, in answer to your question about nondefense capital goods, orders were about 4-1/2 percent above shipments.

CHAIRMAN GREENSPAN. In March?

MR. PRELL. In March.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Ted, your forecast for Japan indicates a fairly respectable pickup in 1995 and 1996, and I saw that the consensus of about 15 international forecasters is very close to your forecast. I was wondering how important fiscal stimulus was in that forecast. We have had instances in the last couple of years where the degree of fiscal stimulus in Japan has been a disappointment. I wondered if you would comment in general about that projected pickup.

MR. TRUMAN. Just one technical point: The pickup as far as this year is concerned is quite modest. I think the fundamental pickup may be seen by focusing on the fourth quarter-over-fourth quarter number. Because there was a big negative number last year, the pickup looks a little better as a percent than we would think, though we are looking for an annual rate of growth in the 2 to 2-1/2 percent range for the balance of this year. But, as Mike mentioned, we have tended to mark things down over the last several forecasts. I think we would have marked things down even more in the absence of this fiscal package, which came in a bit on the high side of people's expectations. I find it extremely difficult to judge Japanese fiscal policy because we don't have a very good baseline, if I may put it that way. They have two or three supplemental budgets a year. The fundamental budget may be good from the standpoint of fiscal rectitude. It may be a great way of running things because they can always drop back to a more restrictive policy in the absence of special supplemental budgets. On the other hand, in terms of judging the ongoing thrust of policy in the context of unusually large output gaps and, as Peter mentioned, the threat of deflation, that probably is not the right assumption to make. I believe the Japanese situation clearly involves some downside risk on balance. It is not an unreasonable forecast, but it probably has an uncertainty band around it that is a bit wider than the forecasts for the other industrial countries.

MR. PARRY. Does your forecast have an explicit assumption about trade relations with the United States?

MR. TRUMAN. We have essentially ignored the trade relations question in the forecast. So, I guess implicitly we are assuming that some time between now and the end of June this particular matter will be settled. There are then two questions. One would be what happens if Congress does go through with the sanctions. The trade and the price implications of that are likely to be pretty secondary; we are talking about $6 billion worth of consumer demand. I guess the simplest calculation would imply a shift to that much more nominal spending, but that is only 0.1 percent of total consumer spending over some period. We have to worry about secondary effects, but we also have to worry about other adjustments if we assume a full pass-through. So, it is not a big number. Also, the overall trade implications are not likely to be very large because most of the presumed shift in demand for luxury cars will go to Germany and other countries. So, in terms of the aggregate effect on trade, not much would be different. That's the easy part of the story. The more difficult part would be to gauge what would happen if we got involved in a so-called trade war. That is a phrase we throw around, but I don't think we really know what it means, or I don't know what I mean when I say it. Probably the most important aspect of that would be the impact on financial markets on the one hand and some broad perception of where economies were going, which I think is likely to be negative. It is hard to imagine that a trade war would not be a negative factor on the whole, but how bad it would be is difficult to judge. So, in that context, we have assumed it is not going to happen!

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Mike, my questions are really along the same lines as those that Mike Moskow asked you earlier. Your response to him frankly is not the response I would have expected from my reading of the Greenbook. A year ago at this meeting we were talking about this issue of neutrality. There was a fair amount of discussion then and at the next couple of meetings about what it means to be at a neutral level in some sense on nominal short-term interest rates and where neutral is. So, when I read this Greenbook, I was led to believe that a neutral nominal rate for fed funds was 6 percent or slightly below 6 percent but that it could be a little higher. There was a phrase in the Greenbook about the core rate of inflation moving up through 1995 and 1996 because that was consistent with an excess of aggregate demand over potential supply. There was also a statement to the effect that the recent bond market rally had pushed long-term interest rates below a sustainable level and that from this point you thought rates would go up. As I read the two alternatives of a higher/lower federal funds rate at the end of the year, the language used to describe each of those also left me feeling that 6 percent was about neutral or maybe a little below neutral. So, your response that neutral was below 6 percent was not what I would have guessed. To come at it from a slightly different perspective, let us assume that the rate got stuck at 6 percent--that we just pegged the rate at that level. To help condition us a little to what we might expect in the midyear review when we come back in July, would you describe what you would expect to be the most likely set of numbers in terms of real output growth, the unemployment rate, and the inflation rate over the next five years that might be associated with a fed funds rate stuck at 6 percent.

MR. PRELL. I don't know that the concept of neutrality was ever particularly well defined, and I think the kind of economic outcome that would ensue from a given short-term real rate of interest is going to vary considerably over time, depending on fiscal policy and other impulses. So, I have problems putting myself in that particular context. But to respond directly to your question about the longer-term outlook, we have shown in previous longer-term scenarios in the Bluebook and elsewhere a declining path for the real funds rate over time because, looking at history, we felt that this was a relatively high real short-term interest rate and one that would not be consistent with stability in the economy. It would be exerting some ongoing contractionary force and overshooting what would be required to stabilize the inflation level ultimately. So, if we redo this projection, we would anticipate, particularly in a context of ongoing fiscal restraint, let alone any balanced budget program that is credible, that over the next several years there would be a decline in the real short-term rate of interest as we moved either toward a condition of stability at potential GDP or even maintained some minor gap so as to bring the inflation rate down gradually.

CHAIRMAN GREENSPAN. It strikes me that the concept probably does not have useful meaning unless we stipulate that we are in an environment in which the budget is balanced, prices are stable, and the exchange rate is stable. The latter, of course, is a function of what other nations are doing as well. To have a concept of neutrality when any of those three is moving, I think is quite ambiguous. But the presumption of a stable economy, maximum sustainable growth at stable prices, and stable exchange rates does raise a question as to what real interest rate structure is consistent with that. Once we move away from that framework, then I think we are dealing with an indeterminate concept. Is there any way, Mike, in which you can define neutrality apart from making certain rigid prespecifications?

MR. PRELL. I don't think so. As I said, I think that a number of environmental factors would alter the implications of a given real interest rate level. Thus, I don't think there is a number for all time.

CHAIRMAN GREENSPAN. The question would be--I'm sorry.

MR. KOHN. I was just going to say, building on what you said, Mr. Chairman, that in the long-run scenario in the last Bluebook, as Mike pointed out, the real funds rate was coming down to stabilize not prices but the inflation rate. One of the factors making rate declines necessary was that the impulse from the decline in the exchange rate was wearing off over time. So you are absolutely correct. I think one has to define neutrality relative to what one expects to happen to exchange rates as well.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Absent supply shocks, Mike, and absent a real contractionary effect from fiscal policy, I would like to talk a little about your inflation forecast and the idea that you believe the risks are fairly evenly balanced around the forecast--at least that is my understanding of what you said. In particular, I was drawn to the fact that the ECI is on a slight upward trend relative to the moderation of the core CPI and that the forecast stays at the low end of most people's assessment of the NAIRU range. Where do you see this in 1996? Do you still see the risks as pretty well balanced around this inflation forecast by the end of 1996? I know that is looking further out and we could perhaps be reaching some cyclical downturn or whatever that would have other effects on inflation. I would like an assessment of what you think the risks are in 1996.

MR. PRELL. Two comments may be useful in responding to that. One is that you characterized the range of possible NAIRU levels as being one that was sort of biased to the up side of where our forecast has been recently. As we are interpreting it, I think we would say that might be a little too pessimistic. Perhaps one of the risks is that the very good news we saw on the ECI through the first quarter of the year is an indication that the NAIRU was lower than is built into our forecast.

MS. MINEHAN. Yes.

MR. PRELL. Basically, our forecast is one in which the economy is operating, at worst, just a shade below the full employment level, or the NAIRU, as we move through 1996. In that kind of environment, one would not anticipate a great deal of pressure toward higher inflation. So, given the recent experience and the factors that suggest what growth rate may be sustainable in this economy without a buildup of inflationary pressures, I think there is a reasonable balance of risks as we look out through next year. Now, we are in a period in which there are some vulnerabilities. The economy is still operating at a quite high level. It is being hit by a shock through the exchange rate channel. As I noted, that shock is not as great perhaps as one would surmise looking at the yen alone, but we think there is an impulse there that is going to tend to bring higher import prices and provide an umbrella for domestic producers of autos and other goods. We quite possibly still have in front of us a significant pass-through of materials cost increases. We can already see that showing up in some industries. It is clearest in industries like paper, but there are hints elsewhere. It is conceivable that this hump that we are looking at in our forecast could be greater and could stretch out more if it generates some broader inflationary expectations than seem to be present now or than we have anticipated in the forecast. So, I think that certainly does pose some short-run upside risk at a minimum.

MS. MINEHAN. Thank you.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I have a question that is related to a couple you have already fielded about looking out over a little longer time horizon. But mine may be a bit more specific and pointed. As I look at the last four quarters of this forecast, it gives off the aura of a steady state in all aspects except one. Real GDP is growing at a rate of about 2.4 percent; nominal GDP is growing at a rate of about 4.8 percent; the profits share is constant; the savings share is constant; the unemployment rate is constant; the funds rate, real and nominal, is constant; and inflation is constant. The one exception to that is capacity utilization, which keeps going down; and that raises a couple of questions. Where is it going? What do you think is the natural rate of capacity utilization? What is it that breaks what I think of as not quite an ironclad but a reasonable 3:1 ratio between changes in unemployment and changes in capacity utilization? In the last four quarters of the forecast, the change in the unemployment rate is zero but the capacity utilization rate goes down by 1.1 percentage points.

MR. PRELL. I think that relationship has varied considerably over decent spans of time historically. So, they have not moved in precise lockstep.

MR. BLINDER. Pretty close, though.

MR. PRELL. We are certainly mindful of there being a relationship over time. By the end of the period, we are moving into the vicinity, if not below, what one might judge to be a natural rate of capacity utilization in manufacturing. This reflects in part the slower growth of goods output in the economy, but it also reflects the fact that we have built into this forecast very sizable increases in manufacturing capacity, largely in response to what has been a very large increase in investment in manufacturing to date and what seems likely to be strong investment going forward. So, that is a significant ingredient in the diminution of capacity utilization in manufacturing. It is one of the factors that provides considerable hope that we are going to see a damping of inflationary pressures and a flattening out of materials prices--that such prices will not be a concern when we get to the latter part of this year and certainly as we move through 1996.

MR. BLINDER. So, if I can interpret your answer: If the demand for goods and services is growing at a fairly steady pace and the capacity in manufacturing to produce goods is growing faster, then you would get ever decreasing capacity utilization in manufacturing. Maybe not forever but--

MR. PRELL. Yes. Obviously, as we move out into 1996 and capacity utilization drops, corporate profits will not be growing the way they have been, cash flow won't be as favorable, and all of these factors will work to damp further increments to growth of the capital stock in manufacturing. We are not going to have an ongoing decline in capacity utilization forever, but this is our short-run forecast. A lot of this is given by the natural lags in the process of adding to capacity so that we think there is a good deal of momentum in this process going out several quarters.

MR. STOCKTON. Just econometrically, Governor Blinder, the relationship between the unemployment rate and capacity utilization that we have in this forecast is well within the historical range that we have had in the past 20 or 30 years. Indeed, capacity utilization is on the low side relative to the unemployment rate.

MR. BLINDER. Is capacity utilization converging to 81 percent? That's what I'm driving at. Where is it going?

MR. PRELL. I'm not sure. I have a concept of a convergence process here, but over time the average and what we estimate as being a natural rate in terms of price behavior is at 82 percent or maybe a bit less. One would anticipate that if we stretch this out, there would be some processes that would probably move us in that direction.

CHAIRMAN GREENSPAN. Any further questions for Mike? If not, who would like to start our round table? President Broaddus.

MR. BROADDUS. Current economic conditions and near-term prospects in our District remain mixed, as they have been for the last couple of months. Most of our business contacts confirm an ongoing moderation in economic activity. In our region as elsewhere the softening in activity is most pronounced in consumer spending and in housing activity. For example, with respect to housing in the Raleigh-Durham area, multiple listings have been running about 25 percent below their rate at this time last year and prices of residential lots have fallen a good bit recently. This is a really striking change in a local area that has been booming for the last couple of years. At the same time, we are seeing continuing growth and strength in at least some sectors and industries. In particular, producers of chemical and paper products tell us that things are still going reasonably well, and they are optimistic about prospects for the remainder of the year--especially, interestingly enough, for exports. Also, tourism, which is an increasingly important industry in our part of the country, is stronger now than it was at this time last year. So, again, activity in our District is mixed. I usually try to avoid using the word "mixed" in describing the economy since it is so vague, but I think that's essentially what it is in our region right now.

Turning to the national economy, the Greenbook forecast is broadly in line with other forecasts that I have seen and it is certainly plausible. But it is calling for an almost perfect landing, a super soft landing, so one naturally has to wonder what might go wrong. I see two distinct and somewhat sequential risks, if I can use that phrase, for the period ahead. First, it seems to me that there is a clear, near-term downside risk. The Greenbook, as everyone knows, is projecting a sharp reduction in GDP growth in the second and third quarters as producers work inventories down. The risk, of course, is that the slow growth in jobs and incomes that presumably will accompany this inventory correction may frighten consumers and possibly precipitate a further reduction in spending. In turn, that could induce producers to cut output further. So, we could get a kind of snowballing effect such as we have had in the past, often in part because of the Fed's reluctance to allow interest rates to decline promptly enough when these kinds of conditions have arisen. Historically, that has tended in at least some circumstances to short circuit the natural stabilizing properties of the price system.

In any case, we all know this kind of cumulative downturn has happened before and conceivably it could happen this time and turn the inventory correction into something worse. Clearly, we need to be sensitive to that risk. If, however, we get through the next couple of quarters okay, including this quarter, and the expansion continues as the Greenbook projects--and frankly I think that is the more likely outcome--then as we move into the final quarter of this year and into 1996, we will face a quite different set of risks. I think most people agree that the level of real GDP currently is above its longer-term potential level. That might be a factor in the recent acceleration in the core inflation rate and in the continuing sharp increases in the prices of many key industrial materials. The Greenbook is projecting, if I have calculated it right, that real GDP growth will average about 2-1/4 percent from now through the end of the projection horizon. If that happens, actual real GDP will move down closer to its potential path. As I see it, the risk is that if the average growth of GDP turns out to be higher than this projection, even moderately higher--say, because the inventory correction is milder or aggregate demand is somewhat stronger than we expect--actual GDP will approach its potential path more slowly and remain above it longer. In that event we could see some considerable buildup in inflationary momentum. Once that happens, it could be very difficult to break. In my view, the latter scenario is still a very real possibility and it is important for us not to let the current moderation in activity and all the talk in the press and elsewhere about soft landings make us forget that risk.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. Economic activity in the Southeast has been slowing recently to a more sustainable rate of growth. Notwithstanding that slower growth, job expansion in the District continues to outpace that for the nation as a whole, although by a somewhat smaller margin than earlier, and the unemployment rate remains below that in the rest of the country. Looking at some of the sectors of the economy, retailers are reporting increasing inventories and slowing sales for both April and early May. Auto purchases in particular were weaker than a year ago, but they seem to be stabilizing now rather than continuing to decline. Tourism is starting to rebound with the return of European visitors to Florida and business travel has continued strong throughout the region.

The reports we are getting on manufacturing are mixed. Production and shipments slowed in April, but new orders and production are expected to rise. As Al Broaddus just reported, paper products and chemicals remain quite strong. In particular, exports of chemicals are responding rather strongly to the dollar's weakness against the deutschemark, and we are now seeing South American customers ordering from U.S. plants as opposed to their German competitors. Building-related materials industries have weakened with the national slowdown in single-family housing, and residential activity continues to slow in our region. Home sales have fallen below last year's levels, but realtors are encouraged by the recent declines in mortgage rates. Multifamily markets, on the other hand, continue to experience rising occupancy and rental rates along with accelerating construction. Nonresidential real estate is pretty much in the same situation. Loan demand is steady in the region, with commercial demand stronger than consumer demand, and banks continue to compete pretty aggressively for business loans. Wage increases remain stable in most areas of the District, and the extreme shortages of unskilled workers that I was reporting, particularly in Tennessee, are now beginning to abate. Skilled construction workers and contractors remain in very short supply generally around the District but particularly in the Atlanta area. Finally, manufacturers are reporting fewer price hikes for both materials and finished products.

With respect to the national outlook, our forecast has a pattern similar to the one presented in the Greenbook, but we have real growth somewhat higher over the forecast horizon. In line with that higher growth, unemployment moves a little lower by the end of 1996 and inflation ends up a little higher--rising to 3-1/2 percent. I think both of these forecasts, the Greenbook and our staff forecast, are within the range of reasonable outcomes. And while growth is probably going to remain sluggish, as we hope it will in the immediate future, there is a possibility of an acceleration later in the year. With respect to inflation, our view continues to be that the rise that we are seeing is largely a cyclical phenomenon as opposed to the continuation of a trend. I continue to be persuaded that since we have not accommodated inflationary impulses in recent years, there is no reason for sustained deterioration in prices to emerge past 1996. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, on balance economic activity in the Seventh District in the last two months seems to have continued the slowing pace of growth in the first quarter--led, of course, by developments in the automobile sector. Confidentially, we have the Chicago Purchasing Managers' Index for May, which I caution will not be public until next Wednesday, May 31. It indicates a resumption in the slowing of the expansion which had been interrupted briefly by a slight uptick in April.

In the last few days, our contacts in the automobile industry reported new cutbacks in production schedules, including three more plants that will be down this week and additional cuts to overtime and line speed at a handful of other facilities. I note that for automakers these are very expensive actions to take at this time because the materials and supplies for the 1995 models have already been purchased under contract. One of the Big Three firms indicated to me that they expected a slower start-up of the 1996 models in September and further cutbacks at that time because of large expected inventories of the 1995 models. Auto and light truck sales appear to be coming in at about the 14-1/2 million units level so far in May, which is approximately 3/4 million units above the April pace but still well below the expectations earlier this year.

Housing activity in the region has been trending down for the last few quarters, but District realtors report some improvement in existing home sales in the past two months. Midwest home builders generally continue to report a relatively higher level of activity in our District than in the rest of the country.

A long delayed spring in the Midwest has damped consumer spending growth, but retailers' optimism seems to have improved with the weather. Retail sales reports have been mixed, with some contacts reporting weak sales in April and the first part of May and others indicating some improvement in sales growth. In the capital goods industries, contacts continue to report strong orders for products such as machine tools, agricultural equipment, and heavy-duty trucks. Steel output in the District has strengthened slightly since the beginning of the year, but growth has been at a substantially slower rate than in the fourth quarter of last year. Some of our steel industry contacts report that orders from the automakers are only now being scaled back. Softening in the domestic demand for steel may be offset by an expected rise in steel exports this year.

In the agricultural sector, corn planting is proceeding at the second slowest pace in 11 years. If the weather improves over the next week or so, there is still a reasonable chance for achieving average yields this year. But even with average yields, production would fall short of current consumption, implying above-average prices in the months ahead. I should add that the weather forecast for the next 5 to 10 days is for more rain. Farmland values and farm equipment sales continued to rise in the first quarter despite widespread talk of trimming farm income and price support programs.

On the employment front, labor markets remain tight, with the District's unemployment rate at its lowest level in over 15 years. But recent weakness in key District industries, especially autos, has reduced overtime and other labor market pressures somewhat. Nevertheless, the surveys continue to reflect relative strength in hiring plans in the second quarter. Pockets of labor shortages in western Michigan, Wisconsin, and Indiana have curtailed expansion plans, adding to recruitment and training costs and combining with other factors to prompt price increases in some industries. Reports on prices generally are mixed. Prices of some materials such as cement, paper, and steel scrap have been increasing. Gypsum board prices were raised about 10 percent in mid-February, but one producer reports some erosion in that increase over the last month, and a planned increase for mid-May was abandoned. Similarly, a number of steel suppliers are reported to have rolled back earlier price increases and the announced July price hike for steel is not expected to go through. In fact, one mini mill has cut its prices for a second time.

In terms of the national outlook, Mr. Chairman, I am in general agreement with the Greenbook.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, the Second District economy remains fairly flat. On balance, the data indicate that the rate of job layoffs is slowing, but job creations and new business incorporations have yet to show any kind of a typical post-recession surge in growth. In April, the unemployment rate rose to 6.8 percent in New York and 6.3 percent in New Jersey. Preliminary reports suggest that April retail sales were up only 3 to 5 percent on a year-over-year basis despite the favorable timing of Easter, and merchants reported widespread disappointment with such growth. Everything seems to be for sale in the greater New York area. The realtors in the metropolitan area reported that existing home sales fell about 10 percent below year-ago levels in the first quarter and that prices were comparably weak. In the same period, vacancy rates for prime commercial office space rose throughout the greater New York City metropolitan area, largely as a result of ongoing corporate restructurings. The boost to business confidence that we had hoped would come from the change of government in New York State is not materializing. The new governor has been completely tied up in knots by the opposition party, which has the majority in the General Assembly in New York State. He is giving up a great deal in order to reach an agreement on a state budget that is still in the "hoped for" stage.

At the national level, we have moved to such proximity to the Greenbook forecast that the closest we can get to a disagreement would have to be described as a rounding error. But we are looking, as I think everybody is, at what developments would point to weakness and what would point to strength in this rather difficult forecasting period. Obviously, the factors pointing to weakness affect mainly the interest-sensitive sectors, with consumer durables weak, especially automobiles, and housing starts down. On the other hand, two of the major channels of monetary policy point to strength. The stock market is near record highs; bond prices are up; higher household wealth and net worth of firms bode well for spending by households and firms; and the declines in long-bond rates have a very positive effect on fixed mortgage rates. Those rates are at about 7-3/4 percent, only 3/4 percentage point above the levels in 1993. So, I think one might anticipate some bounceback in housing. There is a little evidence in that direction, with starts flat in April and the Mortgage Bankers Association survey of applications for purchase up 18 percent in the week of May 12.

Our bottom line is that there is substantial uncertainty about the forecast so that an open mind is very much indicated. We think that the likely risk to the forecast is that growth will be somewhat stronger than both our own forecast and that in the Greenbook, although we don't completely dismiss the notion that Al Broaddus suggested that the consumer could get spooked by present weakness and lose confidence. The place where we are still a bit distant from the Greenbook forecast is on inflation. You may recall that at the last meeting we had inflation up to 3.8 percent in 1996. We have now modified that forecast to 3.6 percent. So, we are appreciably less optimistic than the Greenbook, which has the inflation rate at 3 percent by the end of 1996. There is no reason to say that the Greenbook is necessarily wrong, but perhaps heartened by the fact that we caught the increase in the spending level in the early part of this year we are emboldened to think that perhaps our forecast of 3.6 percent might be more likely. After all, if the Chicago Cubs can be in first place this late in the baseball season, anything can happen! [Laughter]

CHAIRMAN GREENSPAN. No comment. President Minehan.

MS. MINEHAN. Economic activity in the First District is growing at a very modest pace. Payroll employment in most of the major industries in the District is little changed since the end of 1994. Services employment in particular seems to have lost the buoyancy of last year, but it is too soon really to tell whether this slowing reflects a seasonal blip or a more fundamental change. In some ways we are happy to see the hospital industry shedding jobs, but for most individual services industries the monthly data are just simply too erratic to draw many conclusions at this point. Unlike services, manufacturing employment in New England has been in a secular decline, so stability constitutes relatively good performance. In general the old-time industries such as metals, rubber, and plastics, and in particular paper are faring better than high-tech industries, which in New England have a large defense component.

Anecdotal evidence tends to support the statistical picture. Recent retail sales have been disappointing and expectations are lackluster. Furniture stores are especially anxious. Manufacturing results were more positive, but the pace of demand has slowed since last year. First District companies express some relief that auto-related demand has not fallen more in fact than it has. Overseas sales are said to be benefiting from the weaker dollar, and in particular some of our software companies are experiencing upticks in sales as a result of the decline of the dollar. Housing construction is actually holding up a little better in New England than in the nation as a whole. Sales of existing homes in the first quarter are about the same as in the fourth quarter, though down a little from a year ago. Some of our small business contacts report that credit is widely available, with numerous banks calling in search of new lending opportunities. Markets are still quite competitive for most businesses, eliminating the degree to which cost increases in raw materials can be passed on and emphasizing the need for cost-cutting and restraints on wage increases.

Generally, all the states in the region realize that New England's slow recovery has a large structural component as well as a cyclical component. Much attention is being paid in all the states to the cost of doing business. This has had the effect of bringing down egregiously high costs such as workers' compensation over the last couple of years. Recently, there has even been some movement in the area of bank taxes in Massachusetts. But this movement in the states also has increased the level of competition, both among the states in the region and between the states of New England in general and other regions of the country. We are now seeing the remaining large employers in the region openly bargaining with legislatures for the tax and utility cost breaks that they believe are necessary and holding the threat of imminent moves, usually south and west, over the heads of governments. Against the backdrop of general unease about jobs in particular and the economy in general, this is not contributing to an overall sense of confidence in the region. Those changes that inspire real structural adjustments in the cost of doing business in New England, and not just specific industry cost breaks, could be beneficial.

On the national scene, I agree with President Broaddus and President McDonough that it is very tempting to believe the Greenbook. It does describe in the baseline forecast the perfect definition of a soft landing, and I sincerely hope that the staff is right. However, we do remain skeptical--along the lines that President Broaddus ended up with and President McDonough described--that inflation, as measured by the core CPI, can remain so well behaved in 1996 after a relatively small blip in 1995. I hope that President Forrestal is right that inflationary trends are simply cyclical and are not showing some wayward long-term uptick here. But I am skeptical about whether that is true and whether we are just seeing a pause now rather than a somewhat more permanent downward shift in demand. We could see things heat up toward the end of the year, with an untoward impact on inflation.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, growth in the Twelfth District economy still has considerable momentum, although the pace of expansion has slowed recently. Household job growth in the first quarter was fast enough to bring the District's unemployment rate down about 1/4 percentage point since the end of last year. However, growth in District payroll employment slowed about 1 percentage point in the first quarter relative to the 1994 pace. In California, the moderate recovery has continued and the state and local government fiscal climate has improved a bit, although one gets a different impression from recent articles in the Wall Street Journal and the New York Times. Payroll employment growth through April of this year continued at near last year's pace.

Orange County is reported to have moved closer to reaching an agreement with bondholders to reschedule about $1 billion in short-term debt that begins to come due in early July. Some bondholders have been lobbying the state government to help the county honor its obligations as originally scheduled. Thus far, the state government has distanced itself from Orange County's woes, actually leaving it to the county's residents to finance eventual debt repayment. The spread between California state government bond yields and other similarly rated municipal bond yields has remained well below the peak attained when the Orange County crisis first erupted. California's own fiscal situation, we believe, has improved noticeably, although a substantial amount of the debt that accumulated during the recession remains to be worked off. The earlier California deficits were financed largely by a run-up in loans to the general fund of about $6 billion. More recently, state government revenues have firmed with the pickup in economic activity, creating moderate budget surpluses and allowing a payback of about $1 billion of these loans.

Turning to the national economy, our forecast is about the same as the Greenbook forecast. We certainly agree that output is going to be weak in the near term as businesses work off excess inventories. While there is some uncertainty about how sharp this correction might be, we do not expect it to be prolonged. In particular, we expect final sales to keep growing at or even somewhat above the growth rate of potential output through next year. We expect CPI inflation to stay slightly above 3 percent over the period as the beneficial effects of the recent slowdown in wage inflation are offset by inflationary pressures from the dollar and the rising prices of intermediate goods. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Looking at the available statistics, the Third District economy clearly has slowed in recent months across a broad front, including manufacturing, retailing, and residential construction. Looking beyond the statistics, however, I think what we are seeing is a downward adjustment in the rate of growth rather than a cumulative decline in economic activity. Both business and consumer attitudes in the District still seem positive. Rail transportation activity, often a good indicator of manufacturing activity, seems to be bottoming out except for autos. The slowing of office leasing seems to be more from short supply than weak demand in the District, a positive sign for future building, and lower mortgage rates are a positive for housing activity.

On the inflation front in the District, I think we need to look beyond the current statistics as well. Although there is some uptick in the rate of inflation, I doubt that what we are seeing is a cumulative upturn in the rate of inflation, but rather a temporary cyclical upturn that is not sustainable in the current climate of moderating demand pressures, stiff competition for sales, and subdued wage and benefit increases.

Turning to the national economy, my views are similar to what is happening in the District. The national economy in my view is making a downward adjustment in the rate of growth rather than going through the early phase of a cumulative downturn. And the economy is experiencing a temporary uptick in inflation rather than the beginning of a cumulative upturn. Nonetheless, while I am still reasonably confident about the prospects for a soft landing, I think we need to be very sensitive to incoming information.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth District generally remains strong with some signs of modest slowing starting to emerge. Overall, though, the District's sectors generally are continuing to exhibit strength and our directors do report consistently healthy growth across the region. For example, recent monthly employment data show broad-based growth. Our nonfarm jobs in the District were up almost 4 percent in March from a year earlier. In six of our seven states the rate of job growth is exceeding the nation's pace, and New Mexico continues to rank among the top states. Manufacturing activity remains robust across the region. Durable goods producers have been adding jobs at a fairly consistent rate, even recently. In fact, while there has been some reduction in overtime in our auto manufacturing plants, they have continued in some instances to hire new workers in the last three months. There is strong growth in nonresidential building within our District. We also have seen loan growth continuing at double-digit rates over the last two months.

As I said, though, there are some signs of slowing in our regional economy. There has been a little sluggishness in retail sales according to reports from our directors and some of our other District contacts. Residential building activity also has slowed recently. And as others have mentioned, wet weather has led to substantial delays in planting spring crops, pointing to a slightly more difficult year for some of our farmers. Overall wage/price pressures remain moderate in the District, but there are very scattered indications of emerging pressures.

On the national level, our view is in line with the Board staff's projections. We also believe that the projections are subject to considerable uncertainty. Our sense at this stage is that the risks to the projections remain on the up side. A couple of examples: I think that consumer spending could remain strong in future months as employment income continues to grow. Consumer confidence remains relatively good and household balance sheets are in good condition. I think there is some potential strength in our export sector, given the depreciation of the dollar, as others have indicated. The housing sector could turn stronger with long-term rates having come down a little. So, I think there is some risk on the up side and that is a possible area for continued inflation concerns. While I agree that the situation is uncertain, I think we do have to be diligent in watching those inflation numbers. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Employment growth in the Eleventh District has slowed somewhat in recent months. Beginning in the second quarter of 1989, the Eleventh District had 22 consecutive quarters of faster employment growth than the United States as a whole. In the past two quarters, our employment growth has converged with the U.S. rate and it is now only about average. The impact of the peso crisis in Mexico is no doubt an important factor in the relative slowing in the Eleventh District, as trade with Mexico is roughly four times as important for us as it is for the country as a whole. The index of leading indicators for Texas peaked last August and has been fairly weak since then. The weakest component of that index is the Texas value of the dollar because the peso is so important in the Southwest. We are, however, encouraged by the rapid adjustment in the Mexican trade balance and the fact that it has come more from increasing Mexican exports than from declining Mexican imports. On the inflation side, we are not getting new reports of accelerating wages and price pressures in District surveys and in our discussions.

On the national scene, the slowdown has been fairly sharp, even sharper than is reflected in the fourth- and first-quarter GDP numbers. Growth in real final sales went from 5.7 percent to 1.8 percent, a fairly sharp decline. Of course, this has been accompanied by sharp reductions in intermediate- and long-term interest rates. The yield curve is getting considerably flatter. If one looks at a graph of the slope of the yield curve plotted against business cycle dates, it tends to make one a little bit nervous. Generally when the yield curve becomes negative, when short-term interest rates are being increased relative to long-term rates, a recession follows. However, I think, as Al Broaddus indicated, that a natural correction occurs in the economy when interest rates can weaken as a result of weakening economic activity. We have to be cautious not to stand in the way of that for too long. The yield curve is not negative yet, but it is getting closer and that puts us in a more precarious position, given the game of chicken that the Administration is playing with Japan over trade policies. So, the conditions for some unstable financial market activities, both domestic and foreign, are there. We should be cautious in the months ahead.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. The economy of the Ninth District is similar to what has been reported in virtually all the other Districts. The pace of expansion has slowed. But I must say the tenor of the information and anecdotes that have come in suggests to me that, relative to the numbers that we have seen for the national economy, the District economy remains pretty sound. The strength is concentrated right now in basic industries. Pulp and paper production is strong; iron and copper mining is strong; energy exploration has picked up. I would describe sentiment as cautious but not negative. There has been some concern expressed about what might follow from the battle with Japan on the auto parts issue, and whether that could inhibit some of our producers who currently export non-auto related goods to Japan. But industry attitudes don't seem to be particularly negative. Labor markets remain quite tight, especially for skilled workers, but as usual that does not seem to be translating into broad-based wage pressures. A couple of mortgage bankers that I ran into recently have expressed growing optimism. I gather their volume has picked up.

With regard to the national economy, I don't have any serious problems with the soft landing pattern in the Greenbook forecast. I would observe that it not only is a soft landing but it is a rather quick one. It only takes a couple of quarters of below-trend expansion before we get back to what appears to be trend or steady state. And I guess I am struck that even if things work out that well, that means in some sense that we are going to be looking at subpar numbers on the national economy for at least six months, that is, into October or November. We probably ought to recognize that up front and gird ourselves to be patient if, in fact, we get incoming evidence on the national economy of that nature. That's inherent in the forecast and that seems to be what we ought to be expecting, at least as the most likely scenario.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thank you, Alan. The pace of Eighth District economic activity, while decelerating modestly in some areas, exhibits few signs of a pending slump. Unemployment in the major District states remained at 4-1/2 percent in March, well below the national average. Parts of the District continue to report tight labor market conditions for both entry-level and skilled workers. Many businesses in the District report slowing economic activity, but they generally do not view this as a precursor to a sustained downturn in the near future--very similar to other reports we have heard today. Instead, the consensus is for further growth in sales and employment, although at a slower pace than recently experienced. New residential construction in the District is below last year's level, but 1994 was a record year in many areas. Anecdotal reports support the potential for a revival in housing activity with the recent decline in long-term rates. Commercial construction continues to increase at a steady pace as vacancy rates decline and rental rates increase. The office vacancy rate in the St. Louis area, for instance, has fallen to about

13 percent, its lowest level in ten years. Total commercial and industrial loans outstanding at the largest District banks rose 6.1 percent between mid-February and mid-April. Planned auto production at District plants is contrary to the recent national trends. Scheduled second-quarter production of more than 280,000 units represents an increase of more than 3 percent above the number of units scheduled at the time of the last FOMC meeting and is also 3 percent above the number of units produced in the second quarter of 1994. I would associate this with the fact that some popular vehicles, like the Ford Explorer, some minivans, and other models, dominate a lot of the production in our District.

Nationally, the economy seems to be slowing further, though there are reasons for optimism over the remainder of 1995 as a number of people pointed out. But the central concern of this Committee should be inflation, and the pace of price increases is picking up. The annualized growth rate of the CPI was 4.9 percent in April. This index has risen at a 3.6 percent annual rate since December, up from a 2.7 percent rate of increase over the last half of 1994. In contrast to the Greenbook, which has CPI inflation peaking in the current quarter, many private forecasters expect inflation to rise throughout 1995. Most worrisome from the perspective of this Committee are longer-term inflation forecasts that indicate that market participants expect inflation at or above its current level for horizons as long as five or ten years. So-called low inflation of 3 percent or more is endemic in the present U.S. economy and is being built into exchange rates, long-term interest rates, budget planning, contract negotiations, and economic forecasts. We are far from convincing markets of the prospect of moving toward our stated goal of stable prices.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. A few weeks ago, in the last couple of days or so of April, I attended a meeting of over 100 business and civic leaders from northeast Ohio. Martin Feldstein made a presentation to the group and answered questions. His prepared remarks were about Mexico, but during the question-and-answer period, Marty was asked about the economy, the outlook, and policies. He commented at that point that the unemployment rate was too low and we should continue tightening monetary policy until we raise the unemployment rate to about the 6 percent level in order to prevent inflation from accelerating from the current level. After the session the president of one of the companies asked me if I still believed in zero inflation, and I told him that I did. He then asked me how high I wanted the unemployment rate to be pushed up if Feldstein thought it needed to be pushed up to 6 percent to hold inflation steady. Of course, I tried to explain that I did not want the unemployment rate pushed up at all but that the objective of moving toward price stability was in fact to move the unemployment rate down and maintain it at a lower level. After that exchange and then talking with a group of business leaders last week, I was struck by just how difficult it would be to generate broad public support, let alone narrower political support, for the idea of price stability as long as we couch our argument in terms of putting a floor under the unemployment rate. The idea of using a minimum level of unemployment as an instrument in order to achieve the objective of price stability simply is never going to be very popular with anybody.

When I look at unemployment rates in Ohio and also in metropolitan areas and other parts of our District, I am puzzled about why those rates do not fit with the stories that we usually hear and see in print. We have a lot of metropolitan areas that report their unemployment rates officially as under 3 percent. When we talk to the people in the area, they say they have effectively no unemployment. They usually do make the distinction that there are a lot of people who do not have any work to do, but those people have jobs--they work in the city governments and the school districts! The state of Ohio has overall unemployment of 4 percent, the lowest of the big eleven states, and our manufacturing employment is double the national average, measured as a share of total employment.

If we have some idea concerning which we can be reasonably confident in terms of potential, it has to be generally in the goods producing sectors of the economy and more specifically in manufacturing. That is the largest share of the Ohio economy and parts of the central Kentucky economy, down around Lexington and in that corridor. And yet, we don't see that these reported levels of unemployment are being reflected in people's thinking about future inflation, let alone materializing in terms of wage pressures. Our wage increases in the District are well below the national average. Now, one conjecture could be that it is a good thing that there are a lot of unemployed aerospace workers in southern California, given the number of people working and producing motor vehicles in Ohio. Otherwise, we would have a lot of inflation. And if those people in Long Beach find jobs, I guess we are going to have to lay some people off in Toledo! I was in Toledo last week talking to about 100 bankers from within a 50-mile radius, and they were complaining that their unemployment is close to the national average. They said it was around 5.7 percent, and they were trying to attract people into job-creating activities to lower their unemployment rate because--even though the rate is at the national average--it is quite high for this region of the country as far as they are concerned. So I thought, well, if they are successful in lowering the unemployment rate in Toledo we will have to lay off some people in Dayton or Columbus, or else we are going to have too low unemployment and somehow this is going to influence the purchasing power of money.

People that I listen to about what is going on around the District usually perceive the problems to be in somebody else's part of the country. Yes, auto sales have fallen, but that is not affecting the production of cars here and so they feel employment is very good and our area is immune to whatever is happening in Tennessee or wherever. The steel people, similar to what Mike Moskow reported, are experiencing very strong demand but also are planning a lot of additional capacity, especially the mini mills that will come on stream over the next couple of years. One of our directors said that earlier this year he had been looking for a 3 to 5 percent increase in posted steel prices on July 1. He said that will not take place. Even if the steel mills posted the increase, they would not be able to get it, so there is not going to be another steel price increase. Builders report that residential construction is above where it was at this time last year. Nonresidential construction is considerably above where it was before, so the investment side of the economy still looks quite good to us. Agriculture is a different story, though. In particular, there are a lot of concerns about grains. It is reported that because of sharply higher fertilizer costs, fuel costs, and interest rates, average production costs this year for the corn crop may be about 10 percent higher than a year ago, while prices right now are about 10 percent lower. So, farmers plan to make that up on volume once it stops raining.

Turning to the national economy, I have a lot of trouble with the rhetoric about a soft landing. If all the commentary that we see in the press is going to be in terms of an airplane analogy, I wish they would talk about leveling off at cruising altitude. That's because I think a landing should not be the objective at all to the majority of the American public; continuing to fly ought to be the objective. Since I have a general view that a market economy tends to allocate its resources to their best uses in the absence of some real shocks or perverse policies, when I think about where the economy might stabilize in terms of growth rates I try to think in terms of what is going to prevent it--whether monetary policy, fiscal policy, oil shocks, or something else. The one we are concerned with, of course, is monetary policy. So, I ask myself whether I believe that what I see in the Greenbook is at least consistent, whether or not I think it is right. And I have trouble with the assumptions about the interest rate structure, both the level of the funds rate and the rise in bond yields, and the associated growth rates of nominal GDP, real output, and all the component parts. I don't know which one of those is wrong, but I think that one of them is. Either the interest rate structure is too high or the forecast of output and inflation that the staff is presenting is too low, and at some point we are going to have to reconcile those--raise our assumptions about output and inflation or accept the idea that a lower structure of interest rates is going to be consistent with it.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, it seems to me that we are in a classic wait-and-see period here. The expansion is obviously slowing and there are a lot of factors, which have been well aired here this morning, that could take the economy in the direction of either greater near-term or longer-term weakness or strength. It is just too early right now to be making firm judgments about what the economy is going to look like over the forecast period. In the near term, it would seem to me that the inventory cycle and how that plays out is the dominant factor. If final sales hold up, it is hard for me to see how inventories are going to be a terribly big problem. Inventory-sales ratios overall are still modest. I think there are good reasons to believe that final sales will hold up and maybe rebound some. We have the wealth effects from the stock and bond markets. Confidence is still high. Long rates are down and that should help housing and maybe cars to rebound. Those tax refunds that were delayed should kick in here at a very opportune time. And particularly if that plays out well, it seems to me that the out-period risks continue to be largely on the high side. That has been stated in a number of contexts by several people who have spoken already, and I am still very much in that camp. So, I think we are some distance away--I am not sure how far, of course--from a decision point. But in my view we are at least one meeting, maybe a number of meetings away. Thank you.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. The predicted slowdown is well under way. It seems to be pretty widespread, led by housing and consumer durables. Business investment is likely to be off in 1995 relative to 1994, but still strong enough to provide a reasonable cushion during this slowdown period. It appears that only the auto manufacturers have been somewhat surprised by the slowdown and that is even more surprising, given the fact that it was probably one of the best forecast slowdowns that we have had in a long time. The inventory adjustment, which may be largely an auto phenomenon, may well cause the second-quarter slowdown to be deeper than would qualify us for a perfect soft landing or a perfect "riding off into the horizon" at some specified altitude.

The market side seems to be consistent with a sustainable growth outlook. The dollar has rallied; the yield curve has flattened out rather nicely; and long-term rates have declined, partly I hope due to lowered inflation expectations. But there is also a fair amount of attention being paid to the deficit reduction efforts that are under way. I think that the short-term rate declines are probably reversing the overshooting that occurred when the general sentiment was that we were going to be tightening policy. Stock prices generally are up this year but so are earnings, and price-earnings ratios are not dramatically out of line with historical averages. Several people have cited the positive benefits of the wealth effect from both the stock market and perhaps even from the bond market. I think these market adjustments, given the shocks that have occurred in the markets in the last couple of years, pretty well demonstrate the resilience of the markets. Banks and other lenders appear to be able to support growth as needed, so I don't think we are looking at a bottleneck with respect to the availability of credit.

On the price side, cyclical pressures clearly are showing through in the core CPI now, but I don't think we have a firm indication that this is a permanent ratcheting up. We have had some easing off with respect to capacity utilization recently, both in labor and product markets. It doesn't appear that, at least for the moment, wage pressures are consistently building, but I do think we need to exercise a fair amount of vigilance with respect to inflation. Any time we have rising inflation, we have to be wary as to whether we are facing a temporary cyclical situation or whether we are seeing the buildup of a permanently higher inflation rate.

In sum, now that the slowdown is under way, it seems to me that the risks to the economy are a bit better balanced than they were earlier. There are some wild cards in the outlook, and several people have mentioned a number of them. One that I would point to is whether some deficit reduction is going to be enacted into law. And if it is, who is going to be affected and by how much? I don't believe we have adequately built that into our projections. Nor do I think we have adequately factored in the potential trade war with Japan, whatever that may mean. On a not unrelated factor, we have had a shock to the dollar. How that is going to play out in the U.S. economy has yet to be seen. So I agree with Mike Kelley. We seem to be in a wait-and-see posture at this point. The Committee is going to have to continue to assess whether some of these wild cards are going to affect the delicate balance that currently seems to be moving us toward a soft landing, notably how this inventory imbalance will play itself out. So, we have a period of sharp vigilance ahead.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I think I am going to be a minority here. Two things concern me, one of which has not been mentioned at all and that is credit conditions. It was pointed out that there has been a lot of easing of credit terms. At some point that is going to stop. Having arrived here at a very scary time in 1991, I am getting a little nervous that we may be setting ourselves up for another pro-cyclical move in our credit terms that might end up exacerbating the next business cycle. Our surveys, for example, are all saying that credit terms are easing. In the last month I must have had four delegations of bankers through my office complaining not only that their competitors were easing conditions, but that they were easing conditions too much. Please stop me from doing it to myself was their message! That has to be of some concern. I think it also is showing up in the data. I remember getting briefings shortly after arriving here to the effect that never again in this millenium would another office building be built in America, and yet cranes are back on the horizon just 2-1/2 years later. Similarly with household debt, 1.2 billion credit card solicitations were mailed out to the American people in the first quarter of 1995. That is five for every man, woman, and child in the country. So, I suppose if I were typical I would have to say, now that my three-year-old has three cards and my one-year-old has two, that I should keep accepting new cards. This is certainly not the kind of environment that is sustainable. I would point out that the Greenbook forecast for 1996 has a decline in the saving rate from 1995 in order to sustain the rate of consumption growth. Furthermore, even the higher 1995 saving rate is not sufficient to slow the rise in the ratio of installment debt to personal income, which means that it is going to rise even faster in 1996. Well, at some point that is going to stop; forty-four percent of all PCE growth last year was financed through installment debt, and that can't go on forever. At some point either the banks are going to stop it themselves or we are going to stop it when, for example, we have a profits downturn or a cash flow downturn and suddenly all these backward-looking assumptions our examiners make about the quality of the balance sheet begin to go in reverse. I don't know when that is going to happen, but I know it is going to exacerbate the downturn when it comes.

Second, on fiscal policy, we also have to be a bit forward-looking and make the call. The question that Mike raised is whether or not Congress will follow through or whether there will be some moderation in the fiscal policy actions. We can make a bet either way. There are four reasons why I think Congress is going to follow through. The first has to do with the decision to take on Medicare. All the campaign ads attacking the incumbents are already made for 1996. The advocates of Medicare cuts have heard the charge that old people will be pulled out of their sick beds and tossed onto the curb and everything else. These members of Congress already know that they are going to face that kind of attack, so they may as well get some pluses out of this situation. The only pluses they can get are to save the Medicare system from default and reduce the budget deficit. There is no point in stopping now because they already have incurred the political cost. Second, I think the party discipline which was expected to break down on hard votes has not done so. There were 237 votes in the House for the reconciliation bill--they lost 5 Republicans and gained 12 Democrats on the vote. Party discipline is not breaking down and won't this year. Third, in the power structure between the Congress and the Executive Branch, we have a return to what Madison had in mind when he envisioned a spendthrift king being checked by the taxpayers' representatives in the legislature. That was the model for most of the republic's history. It was reversed legislatively in the 1974 Budget Act, and the picture we all have now concerning how compromises are struck is based on the last 20 years. In fact, the default option in fiscal policy is zero. The President who wants to spend more than the Congress does not have a credible veto threat because the default option will produce less than he wants to spend. That is going to become clear as we move through the 12 appropriations bills this fall. In the end, it is going to be Congress that is going to pass a reconciliation bill. Such a bill can't be filibustered and the President will have the choice of shutting down the entire government or signing the reconciliation bill. Every president has bowed in the past and presidents will continue to bow to the more powerful position in negotiations that Congress has. Finally, there is a temptation to lock these changes in place. If the Medicare cuts are enacted, then point-of-order rules will require that any increase in spending be paid for. And if you want to enact reforms that are going to survive, and arguably that is what some of the leadership wants to do, then the time to put those changes in is now.

Logically, I don't understand how the process is not going to end up with a substantial fiscal contraction in 1996. Frankly, I think the yield curve is indicating that that is the expectation. If it is true that we are not going to have growth in the low 2's but growth in the mid 1's--there is a real risk in waiting to find out, assuming the lags in monetary policy remain what they have been in this cycle. If we wait, say, until the autumn, our rate reductions would have their effects about the time that the second round of fiscal reductions would hit in the fiscal 1997 budget. That is certainly a risk. There also is a risk in moving now because we are going to see oscillations in the likelihood of fiscal policy restraint actually passing. I don't think we want to get involved in that game. So, we have a tough call to make.

On net, I think that monetary policy is probably a little tighter than we want it to be, but our regulatory policy is a little easier than we want it to be. What I am afraid we are setting ourselves up for is another situation where we reverse monetary policy, and end up with too easy a monetary policy and too tight a regulatory policy. We end up with the pushing-on-a-string phenomenon we saw during 1991 and 1992. I would urge earlier action in both areas to avoid that.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. As I evaluate the most recent set of economic data, I remain quite optimistic that we will achieve the soft landing projected in the Greenbook, with growth slowing below trend during 1995 and rising back toward trend in 1996, and with inflation remaining contained during the process. Historically, of course, soft landings have rarely been achieved, but this time it seems to me that the preconditions are better. First, any overshoot of potential output that has occurred thus far is relatively small in contrast to past cycles. Second, inflation has remained remarkably well contained. Third, inflationary expectations have not risen. Fourth, we now have clear evidence of a significant slowdown under way, but there is little evidence of any inventory overhang outside the automobile and housing sectors, and I think that limits the possibility of a hard landing.

One of the favorable factors affecting the outlook is that, in the words of the Greenbook, "labor costs remain under remarkable restraint." Increases in compensation are running significantly below forecasts based on econometric wage equations. Benefit cost increases have slowed substantially, and there has been no offset, at least thus far, in the form of higher wages and salaries. In recognition of that fact, the Greenbook has revised downward its forecast of hourly compensation growth. But with core inflation behaving about as expected, thus far at least, the Greenbook forecast of core inflation has been revised downward by less. That strikes me as a reasonable assumption for the short run, but if the compensation surprise persists over the longer run, it is quite likely that we will see compensation restraint showing through to restraint in core inflation, and we will end up with a slightly more favorable inflation trend as well. In that sense, I think the forecast contains some downward risks on the inflation side, but it is really too soon to know whether this compensation surprise will turn out to be transitory or permanent. If it is permanent, that would imply a decline in the natural rate of unemployment. At a minimum, the economy is in effect experiencing a favorable supply shock, which is quite welcome in a period where the economy may have overshot potential output and there is continuing pressure from the prices of intermediate materials and imports.

As I evaluate the risks in the forecast with respect to real GDP growth, they seem to me to be roughly balanced at the present time. I do have a few concerns on the down side. First, I am concerned about the possibility, which Governor Lindsey emphasized, that the personal saving rate may not decline as much from its current first-quarter level of 5.1 or 5.2 percent as the Greenbook assumes, and hence that PCE growth may be less strong. Over the last two years, personal consumption expenditures have been buoyed by strong spending on durable goods. In line with the Greenbook, I think it is quite likely that the growth of spending on durables will slow substantially because a significant portion of the earlier spending probably went to satisfy pent-up demand. Now, it seems natural to expect the personal saving rate as measured in the national income and product accounts, which include expenditures on durables, to rise when spending on durables is weak and to fall when spending on durables is strong simply because durable goods provide a flow of services over a long time horizon and are thus a form of savings from the households' perspective. In fact, this is the assumption that is embodied in the Board's MPS model. Now, the Greenbook assumes that the NIPA personal saving rate will decline, as Governor Lindsey mentioned, to 4.4 or 4.5 percent in 1996, and that is a level somewhat above its 4.1 percent average in 1993 and 1994 when consumption of durables was so strong. But it is well below its 5-1/4 percent average for 1991 and 1992. My concern is that that assumption may be too optimistic, and since consumption is such a large fraction of total expenditures, an error here can have significant repercussions for the forecast.

A second downside risk comes from the potential spillover effects of the inventory adjustment currently under way in the automobile sector, which is forecast to depress real GDP growth in the current and subsequent quarters. I don't want to quarrel with the Greenbook analysis here; it is just that I always worry that there is a possibility of significant repercussions through the multiplier if households cut consumption in response to a decline in income and through the accelerator process if investment slows down in response to a decline in the growth rate of real GDP, especially at a time when capacity constraints are easing. I am simply saying that these spillovers could turn out to be greater than the Greenbook assumes. Governor Lindsey has done an excellent job of describing the risks from fiscal policy, and I share his concerns.

Of course, there are also risks on the up side. As Vice Chairman McDonough noted, these work through interest rates, exchange rates, and the stock market. The Greenbook assumes that the bond market rally is overdone and that a portion of the decline in intermediate- and long-term bond yields will be reversed. If this assumption proves false, it is conceivable that interest-sensitive sectors will rebound, turning a slowdown into a pause.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I'll be mercifully brief as the last speaker. Except for a few details, one of which I mentioned about capacity utilization and a few more which I will mention in a moment, I think the Greenbook forecast is pretty reasonable both on the real and the nominal fronts. I would shade it a bit lower on real growth in the near term, more like DRI's forecast than the Greenbook forecast, reflecting my view that in the short term the downside risks exceed the upside risks. I say that without a great deal of conviction; I don't want to exaggerate the asymmetry that I see. I thought I felt the same way at the last meeting and, in reviewing the transcript for that meeting, I found that that is what I did say then. Between that meeting and this meeting, the annual growth rates in the Greenbook for the second and third quarters of 1995 were both written down by an average of 1/2 percentage point and my prediction of what will happen between now and the next Greenbook is a further reduction of that order of magnitude. It has occurred to me that I could probably make money by forecasting a bigger slowdown when the Greenbook is forecasting a slowdown, and forecasting a bigger acceleration when the Greenbook is forecasting an acceleration.

CHAIRMAN GREENSPAN. That is true of anyone's forecast!

MR. BLINDER. That was the next sentence out of my mouth! [Laughter] If it is not true of the Greenbook, it is an exception to the rule. There are a number of reasons for this tendency of forecasts to underestimate changes. I mentioned this last time, and I am not going to go into any detail here, but a lot of those reasons could be summarized by saying that people underestimate multiplier-accelerator interactions. Janet Yellen mentioned several such instances. As I look across the components, I can find an explanation having to do with consumption, that is, with saving rates, with investment accelerators, with government spending, with fiscal policy --about which I will have one minute's worth to say in a moment--and with net exports as well. It also has to do with the incredible smoothness of the inventory cycle in the Greenbook, something that has not been remarked about. Basically, the level of inventory investment in the Greenbook simply converges to what is essentially a steady state without ever overshooting. That would be a first if it should happen. So, I think the multiplier-accelerator interaction is likely to be underestimated in the forecast, not by a huge amount, but somewhat.

As we discussed yesterday around the Board table, the treatment of the Mexico shock as a one-quarter event is extremely optimistic, as I see it. I think that Mexico will be a drag on our exports for longer than is built into this forecast. Finally, echoing what Governor Lindsey just said, though not quite as strongly and certainly not in as much detail, I now think that the likelihood is for a bigger fiscal contraction than is built into the Greenbook forecast. I was extremely skeptical about this for a long time. But with the passage of the budget resolutions in both houses of Congress and, as Larry said, with the hits having been taken and with the Republican leadership very, very committed--you can either put this as having dug themselves into a big hole or put themselves on a nice platform--I think the prospects for a bigger fiscal contraction are much more likely than they were a few months ago. I want to note that we are not talking about something that is very far into the future. This fiscal contraction starts late this year. On the other hand, as has been remarked, what has already happened to the bond market, the stock market, and the exchange rate is going to be supporting the economy later in the year. In my view, this does not add up to a crash landing by any means. But I think it will not be quite as soft as in the Greenbook. I would say it is likely to be a bumpy landing but not bumpy enough to break the landing gear. [Laughter]

CHAIRMAN GREENSPAN. With that, we will go to coffee.

COFFEE BREAK

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Don, is the price index that Taylor uses the fixed weight or the implicit deflator?

MR. KOHN. I think it is the implicit deflator.

CHAIRMAN GREENSPAN. So, when the GDP figures are revised, his normative funds rate will go up?

MR. KOHN. I would suppose so.

CHAIRMAN GREENSPAN. You don't know what the dimension of that is, do you?

MR. KOHN. If you use the implicit deflator in his rule, you come out with a federal funds rate around 4-1/4 percent now. If you use the CPI rather than the implicit deflator, you are around 5-3/4 percent.

MS. MINEHAN. Yes, it is closer to 6.

MR. KOHN. But using the CPI in the equation for earlier years does not track Committee actions as well as using the deflator. In particular, by persisting at a higher level through the 1991-1993 period, the CPI predicts a much higher federal funds rate than the Committee actually adopted.

CHAIRMAN GREENSPAN. The crucial question that you raise is that of using his equation to capture what we were deciding over the last eight years, and I suggest to you that that may be a little fallacious in the sense that it can be misspecified by the choice of variables.

MR. BLINDER. Just an elementary observation: It does not make a lot of sense to take the same equation with the same intercept and the same coefficients and then change the right hand variable to see how it does. If you had used a different inflation index over the eight years, you would have had a different rule.

CHAIRMAN GREENSPAN. That is exactly right.

MR. KOHN. Except that, Governor Blinder, this rule was not estimated.

MR. BLINDER. Right.

MR. KOHN. He just did something that seemed to make sense and things fell out. But you are right, if you were to estimate it, obviously it would come out somewhat differently.

MR. BLINDER. For both problems.

CHAIRMAN GREENSPAN. Any other questions? If not, I don't have much to add to what has been said in recent meetings because, in fact, the economy is moving pretty much as expected. If you make the adjustment that Governor Blinder requires, namely that forecasts are always a moving average of actual events and they smooth out the real world, that is one of the reasons I recall saying back in our late January-early February meeting that one of the quarters in this first half was going to surprise us on the down side. All I was doing was using the Blinder rule and it always works.

MR. BLINDER. It never tells you which quarter, though! [Laughter]

CHAIRMAN GREENSPAN. No, it never is very helpful in that sense. I think we have to look at this particular outlook in terms of what is engendering the softening. That softening is very clearly the result of an inventory backup, which could be a little stronger than we may expect. I think manufacturing may have a few more months, maybe three or so, of a lot more weakness than is implicit in our forecast. The C&I loan figures may be pointing to a slowdown, but I suspect that we are going to find that the inventory reduction has been slower than we were expecting and that a goodly part of that was an unintended inventory backup. That means that people have not yet come to grips with the squeeze down to a significantly lower rate of inventory investment. As a consequence, I suspect that the third quarter is going to be softer than is projected in the Greenbook. Were it not for the fact that inventory levels, no matter how we measure them, remain quite low, I would say the concern that a number of you have expressed with respect to the potential for reduced inventory investment working its way through the income structure and inducing a weaker consumption pattern in a historically typical way would be something that we ought to be concerned about. But no matter how we look at the numbers, the levels just remain too low for the inventory sector to be a matter of grave concern. And because other sectors of the economy such as capital goods and exports, and I might add homebuilding, are showing signs of sustainability, we don't have the conditions that would induce the underlying system to crack at this particular stage.

The reason I asked Mike Prell earlier about the size of the gap between orders and shipments is that I suspect that we are going to see new orders coming down in capital goods markets. The only question is whether they will drop far enough to breach the shipments level and turn unfilled orders down. I think that is a mixed call at this stage, but because there is so much of a gap there, we have leeway for fairly significant short-term weakening. I must say that I don't expect all that much weakening in the expansion, largely because the profit picture still looks increasingly supportive. That is, as the Greenbook indicates, the earnings surprises on the up side are still 2 to 1--profits are coming in more favorably twice as often as unfavorably. The first-quarter profit numbers that were published are just gangbusters and profit margins are still rising. This is really quite extraordinary, given the extent of the slowdown that is involved here. What history tells us is that we just don't get a capital goods contraction in the context of rising profit margins, rising stock prices, and long-term interest rates that tend to be falling. That may occur--it undoubtedly will at a later stage of the expansion. The business cycle is by no means dead, but it just does not make any sense in an historical context to presume that we will be looking at significantly weaker capital spending. Certainly, nonresidential building continues to strengthen and we are getting, as many of you have indicated, a gradual, underlying healing of that problem. Indeed, the issue may be more what Governor Lindsey is concerned about: There may be too much nonresidential construction going on already or at least showing signs of being overdone, and I must say I have a certain sympathy for that kind of concern.

We did get a surprising statistic from the mortgage bankers last week. I don't know whether to believe it or not, but the weekly seasonally adjusted figure on home purchases as reported by the mortgage bankers spiked sharply upward, and it does not look like a seasonal adjustment problem because the unadjusted number was the highest that we have seen in a very long time. Moreover, all the qualitative evidence--the traffic, the intentions to buy, the consumer confidence elements associated with housing--is in the direction of a rise in housing activity. The reason starts are weak is that we have a very heavy overhang of unsold homes through which the market has to work its way. The underlying quality of this market is pretty sound.

In sum, there is no evidence of a cumulative decline in the economy. We have a very odd problem in the published inventory data, but we also have one in the unpublished data that involves stock adjustment inventories. In the housing industry inventories of unsold homes will continue to hold activity down. In the motor vehicles area I think, as President Moskow indicated, that the May data on sales look somewhat stronger at this stage than those for April, although by no means as strong as they have been. Nor, with all the weakness that we are seeing, do the initial claims for unemployment insurance suggest that this economy is in a continuous weakening phase. The evidence does suggest that there are going to be a lot more surprises on the down side in the very short run than we may be prepared for.

The debt issue that Governor Lindsey raises is an interesting one, and I would only respond by suggesting that part of the problem with this big increase in installment credit, which really is outsized, is a significant displacement coming from the mortgage market. Up until fairly recently, a rather substantial amount of indirect financing for consumer durables has come from the turnover of existing homes. That turnover has induced large realized capital gains that have been financed in the mortgage market. Those funds are going disproportionately into the financing of consumer durables. The slowness of the mortgage market in relation to the level of existing home sales is suggestive of the fact that less of that is going on, and it may be that--1-1/2 billion credit card solicitations--is that what you said?

MR. LINDSEY. 1.2 billion in the first quarter.

CHAIRMAN GREENSPAN. Is that an official figure? Where did you get the number?

MR. LINDSEY. The bankers gave it to me.

CHAIRMAN GREENSPAN. No kidding! That is scary!

MR. LINDSEY. It is scary!

CHAIRMAN GREENSPAN. Every dog and cat and moose has a credit card! I think that part of the problem is merely a shift in the form of financing, but I don't think we can look at those figures without some concern. I do agree that the easing of credit terms is a potential problem down the road. I say that even though, according to the bankers, credit terms are still tighter than they were in the late 1980s; but that is scarcely the standard that one should employ, as I think one of our colleagues indicated the other day.

I would say that there is a bigger problem down the road related to all of this. If in fact the economy tracks the Greenbook forecast, it is inconceivable in my judgment that it will continue doing so for an extended period. That is because if this happens, the stock market is going to go straight up and then straight down. And on the down side there will be an awful lot of demand implosion. So, if this economy works as well as the Greenbook suggests, the really serious problem that we will have in setting monetary policy, which we are going to have to question ourselves on, will be how we should respond to asset price bubbles. We know how to respond to product price inflation and the instability that is associated with that. You may recall that when we moved in February 1994, one of the reasons was that an asset price bubble was building up. Little did we know that it was much bigger than we had imagined and that it was more in bonds than in stocks. In retrospect, it was terribly fortunate that that bubble got pricked at the appropriate time. I am not sure that one can make a forecast that is as stable as the one in the Greenbook, because implicit in such a forecast, given human nature, are actions that will probably upset it and that concerns me.

So, one of the reasons why the real world is not very apt to look like the Greenbook is that the way the real world works is not like "that" but more something like "this." [Secretary's note: The Chairman made a hand gesture indicating a smooth path when he said "that" and an uneven path when he said "this."] The only problem is that we don't know what "this" is until after the fact. So, all forecasters can do is to draw straight lines through things. The disequilibrium that is implicit in this forecast is an asset price bubble, and I am not sure at this stage that we know how or by what means we ought to be responding to that, and whether we dare. There is always the question, if we make a preemptive strike against an asset bubble, of whether we could blow the economy out of the water in the process. So, it is a slightly nervous-making type of situation. I almost hope that the economy will be a little less tranquil, buoyant, and pleasant because the end result of that is not terribly helpful.

On the product price inflation side, I think what we are looking at here is strictly the expected slowdown in productivity that occurs as a consequence of fixed costs not being spread over the aggregate volumes that we have seen. As unit labor costs rise accordingly, we will be looking inevitably at the beginning of a decline in profit margins but not enough of a decline to prevent final prices from accelerating modestly. However, that is a cyclical phenomenon and not one that I would be terribly concerned about. I am certainly not as concerned about that as I would be about an asset price bubble, which is down the road, granted, but still something to be concerned about.

Fortunately, as I see it in the short run, none of this is relevant! [Laughter] We can, as I see it, just do "B" symmetric and wait until the next meeting. I think it is very unlikely that the next meeting is going to be one where we are going to be confronted with an economic expansion that is picking up, because my suspicion is--I don't know whether I'd pick the specific timing that Governor Blinder did--that the rate of expansion is going to be shading down a little in the period immediately ahead. But I would not expect the slowing to be enough to undercut the fairly solid underlying status of this recovery for a while, perhaps a good while yet. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I agree with your recommendation for "B" symmetric. I think that the last time we were, somewhat appropriately, more concerned about inflation than we need be now, even though I think we must stay alert. And therefore the "B" symmetric resolution is the appropriate one.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I, too, am in agreement with your proposal, Mr. Chairman. There are a couple of things that I think we need to be concerned about. First, where are the uncertainties? You have talked a bit about that. And secondly, what are the costs of being wrong in either direction even if the uncertainties are more or less balanced? At this point, I think the risks are reasonably balanced. But inflation could be higher than the Greenbook projects, and my own assessment is that the costs of being wrong on that side are a little higher than the costs of being wrong on the other side. You indicated that you are inclined to the view that the uptick in inflation is cyclical; other people have mentioned that as well. I am concerned about the possibility that it is not necessarily all cyclical. If it isn't--and the Greenbook has built in an estimated 1/2 point increase in the core CPI rate in 1996 versus 1994--even recognizing that 1994 was pretty low, I keep asking myself whether we should be satisfied with that and whether that kind of outcome is something to be sanguine about going forward. Are we certain enough that this is cyclical and not some uptick in the trend, or is it potentially an uptick in the trend if in fact we are experiencing a pause rather than a more permanent downturn in the growth of demand? So, I agree with your comments; I agree with your proposal. I think I am just a little more nervous about the inflation prospects.

CHAIRMAN GREENSPAN. The way I put it is that I am more nervous about the asset bubble than I am about product prices. That is not to say that I would disagree with you. There may be more than a cyclical element in here that we won't know about until after the fact. I think most of it--

MS. MINEHAN. Is cyclical.

CHAIRMAN GREENSPAN. Is cyclical, but such inflation is not acceptable as far as I am concerned. President McTeer.

MR. MCTEER. I think the risks are somewhat unbalanced to the down side, and I think the recent performance of the economy would argue for some easing today, but the markets have already done that, both interest rates and the exchange market. I think they already are providing some support for the economy. I agree with your recommendation.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I certainly agree with your recommendation, Mr. Chairman. When I made my economic statement, I pointed out that we face two risks currently--a continuing longer-term inflation risk but also a not inconsequential possibility that the current weakness in the economy may cumulate. If the latter situation were in fact to materialize--again that is not what I think is going to happen but, who knows, it certainly could in the months ahead--it would be very nice for us to be in a position to react to that quickly and promptly. That would be a preemptive move against recession which would be the flip side of the preemptive move we made against inflation, I think with some success, last year. The problem, of course, is credibility. If we were to take an action that was in any way seen as an aggressive easing move, that could do great damage to the credibility that we have built up over a long period of time at some cost. That is why I think it would be very nice if we could find some longer-term nominal anchor for monetary policy in order to impress our longer-term strategic goal more firmly in the public mind. We had a discussion of this a couple of meetings ago. At that time I said that I thought it would be nice if we were to make an explicit announcement that we were adopting the language of the Neal Amendment as our longer-term objective. I am less concerned, though, about what the form of the anchor would be than that we do something to tie that down precisely so that we can deal with an increase in the downside risk--should that materialize--flexibly and effectively without giving up all of the gains we have made on the credibility side in recent years. In any case, I would hope that when we get to the July meeting and we have our usual discussion of longer-term goals, we might give that point some attention.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support "B" symmetric.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I support your recommendation. I agree that in the short term the risks seem reasonably well balanced, although I share the same views as President Minehan about emphasizing the possibility that inflation may be a little higher than our forecast in the shorter term. I would suggest, however, that if we in fact are somewhat agreed about the direction that we would like to see the rate of inflation go in the longer term, it will make us rather cautious in moving toward lower rates.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I think we ought to be fairly happy with the course of monetary policy over the last year and the results that it has achieved in the economy. There obviously are uncertainties surrounding the forecast. The concerns that you point to with respect to the asset price bubble are real, but I think that those are down the road as you have indicated. We have the luxury for a change of sitting back and letting events unfold a little longer before we have to make a move. So, I support your recommendation of a "B" symmetric directive.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I think the wisdom of your recommendation is evident, and I'll adopt Bob McTeer's words as my own.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I support "B" symmetric.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support "B" symmetric as well. I am concerned about the asset bubble problem you mentioned. I think it is a real one down the road. We may see some signs of an increase in the inflation rate in coming months, but at this point it appears that that increase will be transitory. There is some danger of giving up ground on our progress toward price stability, so I think it clearly would be inappropriate to respond too hastily to any signs of weakening in real activity. But in light of the evenly balanced risks that I see at this point, the current stance of monetary policy is appropriate.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I agree with "B" symmetric. It seems to me that this is a time to keep the monetary policy powder dry.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I agree with "B" symmetric. I do have concerns, as I mentioned earlier, that the inflation may be more than cyclical, and I agree that it is wise to wait and see.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I, too, agree with "B" symmetric. The only comment I would add is that when I submitted my Humphrey-Hawkins numbers earlier this year, I was relatively negative about the inflation outlook, at least for this year. Unfortunately, nothing has happened to change my view about that. On the other hand, looking at all the incoming information on the economy, I am marginally more confident that this may turn out to be a temporary acceleration in the core CPI, and I don't see any reason to take action at this juncture.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I support your proposal for "B" symmetric. I think that an unchanged funds rate is warranted given the Greenbook forecast with risks roughly balanced.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I agree with no change at this meeting.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I favor "B" symmetric as well, Alan. I think our focus has to be on pursuing a policy that contains current inflationary pressures and is aimed at making progress toward longer-term price stability. I am not, as you know, a great fan of short-run fine-tuning. I think we are seeing a slowdown from a nonsustainable rate of growth, and we should not be trying to fine-tune in those circumstances. We may have a moderately tight monetary policy, but that is appropriate in view of the tremendous stimulus that took place in 1991 through 1993. The other comment I would make, and we heard some commentary on this issue today, is that any reaction to fiscal policy restraint, certainly any reaction to the prospect of it, is very dangerous. Even if we do get some fiscal restraint, I would argue that the best thing monetary policy can do is to provide a stable price backdrop against which the real adjustments that need to take place in that event can occur most effectively.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I support your proposal, Mr. Chairman.

CHAIRMAN GREENSPAN. Would you read the directive.

MR. BERNARD. The directive is on page 15 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months."

MR. LINDSEY. I think you mean "might."

CHAIRMAN GREENSPAN. It is symmetric.

MR. BERNARD. I used "would" for both.

MS. MINEHAN. Somewhat or slightly?

CHAIRMAN GREENSPAN. It doesn't matter.

MS. MINEHAN. So we use "somewhat" for both.

VICE CHAIRMAN MCDONOUGH. As long as they are the same.

CHAIRMAN GREENSPAN. As long as they are the same for both. Do we usually use "would" when the directive is symmetric?

VICE CHAIRMAN MCDONOUGH. Yes.

MS. MINEHAN. Yes.

MR. BERNARD. There have been exceptions, but "would" is used most of the time.

CHAIRMAN GREENSPAN. I think we should use "would." We are voting on "B" symmetric. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Blinder	Yes
President Hoenig	Yes
Governor Kelley	Yes
Governor Lindsey	Yes
President Melzer	Yes
President Minehan	Yes
President Moskow	Yes
Governor Phillips	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. The next meeting is the multiple day meeting, July 5th and 6th. I gather it will be held in Dining Room "E" because we are going to be renovating this room. This is as early as we have ended a meeting in quite a while. [Secretary's note: The meeting ended at 12:15 p.m.]

END OF MEETING